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Gaps in Post-Crisis Financial Reforms

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22nd Hyman Minsky Conference
Building a Financial Structure for a More Stable and
Equitable Economy
17-19 April 2013,
Ford Foundation, NYC

Gaps in Post-Crisis Financial Stability Reforms

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What's the connection with the theme of the conference?

- Financial stability does not exist in the absence of the right institutions
- In building those institutions general law might have to be amended/reformed or just ignored
- E.g., banks require special insolvency laws which not only bypass general insolvency law but also ignore shareholder rights grounded in general company law
- Without new International law-based supervisory and policy structures international banking will become a thing of the past sooner or later

What else?

- Another theme of the conference is building the right financial structure for a more equitable and stable economy?
- How?
- By reconceptualizing what banks and different forms of banking are all about?
- Can the international dimension be ignored and what reforms are required in the global financial architecture?

FINANCIAL STABILITY REFORMS PREVENT FINANCIAL INSTITUTIONS FROM BECOMING TOO BIG

- VOLCKER RULE: BAN ON PROPRIETARY TRADING & INVESTING SPONSORING SHADOW BANKING FUNDS
- SIZE LIMITATIONS: Cap on assets/liabilities (Dodd-Frank cap very lax)
- STRUCTURAL REFORMS – e.g., UK's ring-fencing
- CAPITAL SURCHARGES: 'a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. To provide a disincentive for banks facing the highest charge to increase materially their global systemic importance in the future, an additional 1% loss absorbency would be applied in such circumstances.' (Basel Committee, 2011)

But how about structural reform?

- Other than the S&L debacle of the late 1980s and early 1990s, which saw 747 thrift failures (out of 3,234) but had nothing to do with failures of individual systemic financial institutions, the US suffered no material financial setbacks during the separated-banking era. An exception was the 1984 failure of Continental Illinois Bank and Trust Company.
- A consequence of Glass-Steagall may have been the progressive dominance of US investment banks in rapidly evolving offshore and onshore capital markets worldwide.

Glass Steagall's success

Focus matters!

- The US investment banks' global offensive was so successful that virtually all the major universal banks in Europe launched ambitious efforts to develop investment banking divisions of their own.
- By the early 1990s American investment banks basically dominated their industry world- wide, with a market share approaching 75% in terms of transactions volume. As a consequence, investment banking developed into one of the top US export industries.

So are the obstacles to structural reform real?

- Scant evidence of true economies of scale attached to large bank size
- Diversification/conglomeration increases agency conflicts within the bank and destroys value, although diverse income streams do give the bank a more stable income base
- The diversification discount means that shareholders probably get a worse deal to what they would be getting if each major line of operations was a stand-alone business

Laying out the business case for smaller and more focused banks

- Smaller banks are much better placed than larger banks to produce and utilize critical soft information that is often an excellent way to judge creditor quality alongside hard data that is of course available to both large and smaller banks.
- Larger, more centralized banks base their credit approval decisions more on hard (verifiable) information, whereas smaller (more decentralized) banks can more easily use soft information.
- As a consequence relationship banking could suffer. This might be particularly important for the financing of smaller and informationally opaque firms, and also has implications for the optimal decision-making structure of larger financial institutions (see Stein, 2002; Liberti, 2003; and Strahan, 2008)

A New Model for Structural Reform?

- But even if the financial stability and fostering of ethical behaviour rationales are more than enough to justify structural reform, where do you set the boundary?
- Essentially we have three distinct banking business models (Lewellyn 2011)
- Retail, savings, and loans
- Wholesale lending
- Investment banking

Is there an effective alternative to structural reform?

- Ownership restrictions
- Since diffuse ownership diminishes corporate governance monitoring incentives and fosters short-termism
- Either big banks turn into stakeholder owned banks
- Or restrictions are placed on short-term shareholders which means that only the state and pension funds could become bank shareholders
- These ought to be seen as intolerant restrictions in a capitalist society

Is there a need for a (formal) global governance system for International Finance?

YES

- BECAUSE GLOBAL FINANCIAL INTEGRATION AND MOVEMENT OF CAPITAL FLOWS CANNOT BE PROPERLY MAINTAINED IN THE ABSENCE OF STRUCTURES AND INSTITUTIONS SAFEGUARDING SYSTEMIC STABILITY
- RELIANCE ON PERFECT MARKETS WAS A COSTLY ILLUSION
- BUT CANNOT HAPPEN WITHOUT A NEW INTERNATIONAL TREATY IN THE FORM OF BRETTON WOODS OR WTO

FOUR AREAS OF TREMENDOUS CONCERN

- Effective supervision and monitoring of systemic risk in global markets, esp. risk originating in the shadow banking sector**
- Effective supervision of big cross-border institutions, so-called Globally Significant Financial Institutions (G-SIFIs)**
- Effective understanding and management of risk in the financial sector, esp. risk attached to financial innovation, and standard production**
- Effective resolution of cross-border financial institutions(G-SIFIs), and more importantly of cross-border financial groups.**

Global Policy Issues

A global governance system for international finance has to also redress a number of shortcomings enshrined in the current soft law based approach:

- Legitimacy/accountability
- Effectiveness
- Over-reliance on the private sector
- Address the development/poverty eradication and sustainability objectives

Let's for instance examine the issue of shadow banking

Essentially this quote from a recent speech by BoE's Paul Tucker encapsulates the situation in global markets:

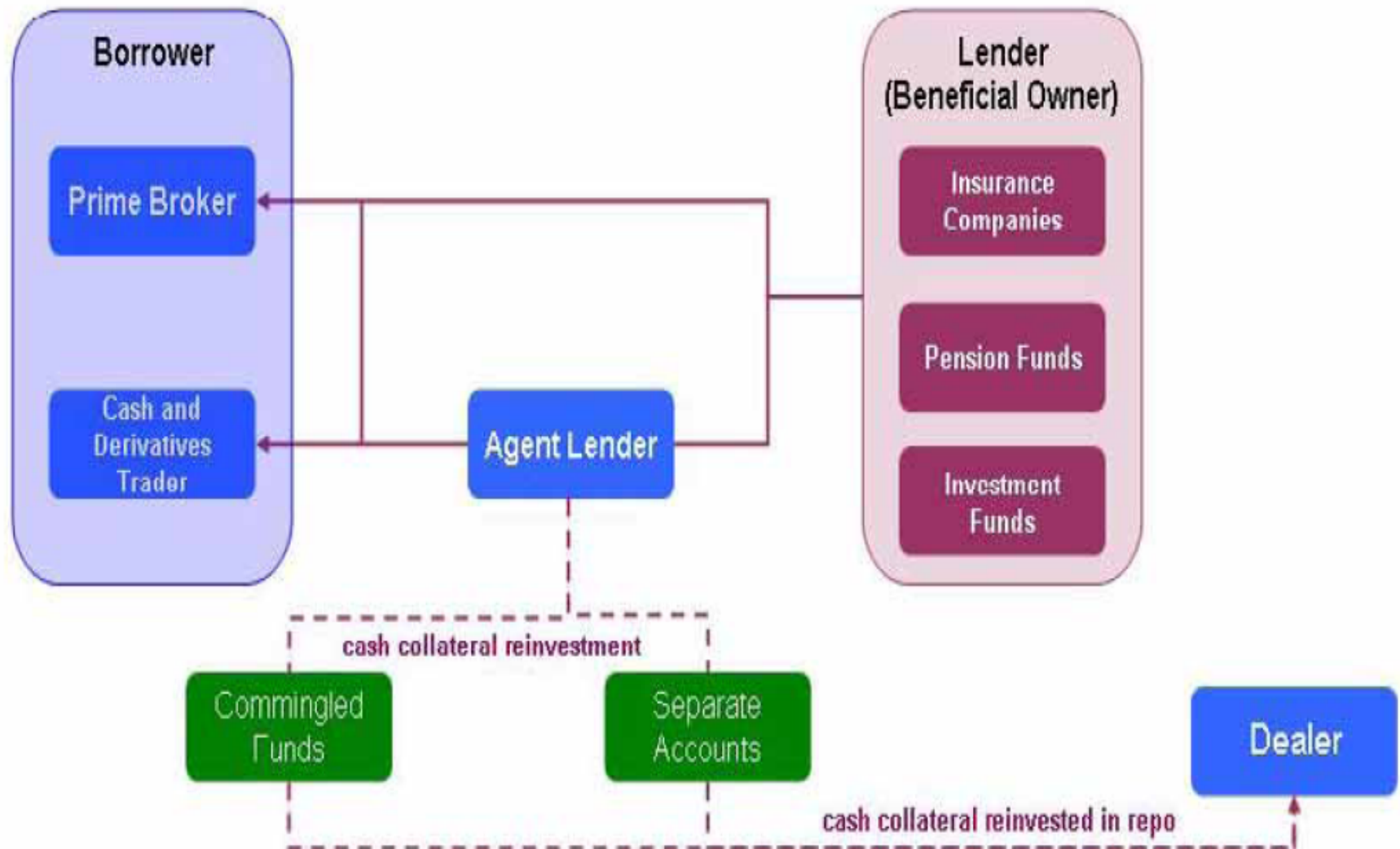
'But it is also true that anyone holding a securities portfolio can build themselves a shadow bank using the securities lending and repo markets. One simply lends out the securities at call for cash, and then one employs that cash ...' ¹

1. Paul Tucker, '**Shadow banking: thoughts for a possible policy agenda**'
Speech given by at the European Commission High Level Conference, Brussels,
27 April 2012

The Securities Lending Chain

Source: Interim Report of the FSB Workstream on Securities Lending and Repos

Exhibit 1: The securities lending segment



Note:

These short-term cash flows:

- First, intensify asset bubbles (not causing them, asset bubbles are probably the result of loose monetary policies, global trade imbalances, and irrational exuberance);
- Second, might inflate commodity prices and distort forex markets.
- Distorted commodity prices and exchange rates are seen factors that hinder the stability and development of international trade
- In addition, inflated commodity prices intensify global trade imbalances in favour of commodity exporting countries

The Macro-prudential supervisor

The first pillar, the global systemic risk (macro-prudential) supervisor that would monitor both macro-economic developments and the state of the global financial system, seen as encompassing national and regional financial systems and the shadow banking sector, should comprise a revamped IMF.

The entanglement of financial sector stability and solvency with sovereign indebtedness and vice versa means that only a revamped IMF could effectively discharge the duties of a global macro-prudential supervisor.

Micro-prudential Supervisor

The micro-prudential supervisor could exercise direct oversight over G-SIFIS, whether banks or other financial institutions, such as insurance companies, with a large cross-border asset or liabilities base. Its remit could gradually extend to cover certain wholesale segments of global derivatives and securities markets

Global Financial Policy and Knowledge Supervisor & A Global Resolution Authority

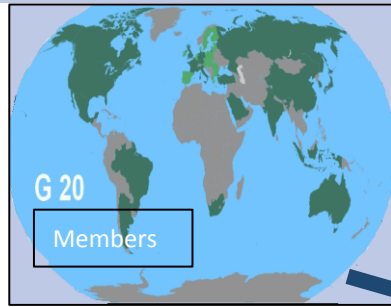
- The third pillar should comprise the OECD and the research ‘division’ of BIS and should be dedicated to the task of production of new regulation and examination/evaluation of emerging risks, especially by means of various financial innovations. The new body could be called the Global Financial Policy, Regulation, and Knowledge Organisation and should be the directing mind of International financial regulation.
- The fourth pillar should comprise a newly established Global Resolution Authority which should be strictly dealing with the resolution of big cross-border financial groups on the basis of a single resolution and insolvency model.

A General Principles/Shared Values Framework

I view three principles as beyond dispute:

- (a) safeguarding the global public good of financial stability,
- (b) protecting the robustness of financial infrastructure,
- (c) safeguarding the integrity of global markets and protecting investors and consumers of financial services from abusive practices and products.
- (d) To these principles I would add a fourth, even though, it may only be seen as a supplement to the principle of financial stability. All actions of the new system should be cognizant of their impact on the ability of open and competitive financial markets to foster economic growth and reduce poverty, when the objective of financial stability is not compromised.

UMBRELLA TREATY



Top 3
Non-
G20

Governing Council

**Macro-
Prudential**

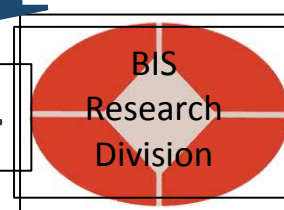
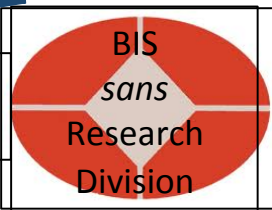
Global Systemic Risk
Supervisor

**Micro-
Prudential
Authority**

Coordination

Global Financial
Policy, Regulation,
and Knowledge
Organization

**Global
Resolution
Authority**



State of global
financial system :
incl. national, regional,
international banking
sector, shadow
banking sector

G-SIFIs with large
cross-border asset/
liability base

Global derivatives
and securities
markets

Production of
new
regulation

Evaluation of
emerging risk

Resolution of
cross-border
financial
groups

Emilios Avgouleas 18/04/2013

Proposal by Emilios Avgouleas,
**Governance of Global Financial
Markets (2012)**

A Global Passport?

- WTO signatories would have to agree to a modification of GATS that renders the ‘prudential regulation carve out’ inapplicable for financial institutions governed by the proposed governance scheme.
- This should not prove an insurmountable problem, since with the scheme authorities taking important steps to safeguard systemic stability further liberalisation of global trade in financial services should be able to return to the WTO negotiations agenda.

BUT SURELY THERE IS NO PRECEDENT? WELL NOT QUITE

THE EUROPEAN BANKING UNION SHALL COMPRISE:

- 1. A Single Supervisory Mechanism (SSM)** which will extend to all 6,000 eurozone banks
- 2. The SSM will be followed by a common bank recapitalisation policy and fund,**
- 3. a single resolution mechanism and,**
- 4. ultimately, a single deposit insurance scheme.**